Empower Investments Capital Markets Perspective

Week in Review: September 12th – 18th

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	30,822.42	-4.13%	-15.18%
S&P 500®	Lg. Cap Eq.	3,873.33	-4.77%	-18.73%
NASDAQ Comp.	US Equity	11,448.40	-5.48%	-26.82%
S&P Midcap 400©	Mid-Cap Equity	2,380.28	-4.71%	-16.25%
Russell 2000®	Sm. Cap Eq.	1,798.19	-4.50%	-19.91%
Stoxx 50	Europe Eq.	3,500.41	-1.95%	-18.57%

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
FTSE 100	UK Equity	7,236.68	-1.56%	-2.00%
Nikkei 225	Japan Equity	27,567.65	-2.29%	-4.25%
EEM:US	Emkt. Equity	$37.79	-3.10%	-22.64%
EFA:US	Non-US Equity	$60.40	-3.27%	-23.23%
UST 10y (yield)	US Treasury	3.45%	+0.14%	+1.94%
Bloomberg U.S. AGG	Fixed Inc.	2,063.53	-0.93%	-12.38%

Past performance is not a guarantee of future results. Investing involves risk, including possible loss of principal.

One of my earliest memories is going to work with **my granddad**, a longtime railroad yardman. While I'm certain it broke just about every rule in the book, he **briefly let me "drive" a locomotive** (or, in the more OSHA-compliant version of that memory, maybe he just let me sit near the controls while the huge diesel engines idled ominously, I really don't recall…) I must've been only five or six years old, but **I still remember being terrified that the whole train would suddenly lurch forward and wipe out a grocery store or a daycare center while I was at the controls**.

That terror – or something very much like it – is probably keeping Jerome Powell awake at night, because like **the engineer on a freight train, Powell's Fed has its hand on the throttle of the economy in a very real way**: push the handle too far forward and the economy runs out of control; pull backward on the brake too hard, and the whole train derails.

To at least some extent, that's always the case given the immense power the Fed wields in our modern, central-bank driven economy. But given where we find ourselves in the economic cycle today, **every twitch in Powell's throttle hand**, every move he makes toward the brake handle **has the potential to do catastrophic damage** to one constituency or another. That point was **illustrated in a big, noisy way on Tuesday**, when the latest look at **consumer inflation** from the Bureau of Labor Statistics made it clear that the US economy was **still chugging along a little too fast**, keeping the whole thing dangerously close to running off the rails[1]. **US stocks had their worst day since mid-2020 as a result**.

It wasn't so much the CPI reading itself that caused all that squealing - in fact, **headline CPI wasn't too far off economists' expectation**s. No, instead it was the fact that **core inflation**, which deliberately excludes things like food and energy because prices for those commodities bounce around too much to accurately capture significant trends, **is still running unexpectedly hot**. To that point, a 10%-plus drop in gasoline prices was more than overwhelmed by surprisingly robust gains in prices for all sorts of other stuff to such an extent that even *headline* inflation inched higher.

That matters, because it illustrates that **if left unchecked, inflation is dangerously close to becoming entrenched in areas that, unlike gasoline prices, aren't likely to relent anytime soon**. It was also enough to convince investors that Powell, who might otherwise have been inclined to ease up a little bit, might instead have to yank on the brake lever even harder than he already has. Perhaps unsurprisingly, interest rate traders reset their expectations about this week's Fed meeting in response: the "50-basis point crowd" who were betting that the Fed might boost rates by "only" 0.50% this week, suddenly

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[1] https://www.bls.gov/news.release/pdf/cpi.pdf

seemed to leapfrog over the "0.75 crew" and went straight to 1.00%, and as of Friday, there appeared to be **a roughly one-in-four chance that Powell's Fed would produce a full 1.00% of Fed-sponsored tightening**[2]. If so, it would be the first time that's happened since the inflation-soaked 1970s and 80s.

It also probably didn't help that **Tuesday's uncomfortably high CPI was followed by an almost equally hot (and sticky) Producer Price Index** release on Thursday. At the least headline PPI figure declined a little bit as a result of the rapid drop in energy prices[3], but markets still found it difficult to be comforted, because while it reflected a long-awaited (and accurately forecast) decline in goods prices, last week's PPI report also included a too-robust acceleration in prices for services. **Bottom line?** Thursday's PPI release showed pretty much the same thing as Tuesday's CPI release: if **you look too far beyond gasoline prices, inflation is still rising too fast for comfort**.

Moving on.

If you're wondering whether the extended riff above comparing the US economy to a locomotive and Chairman Powell to its brakeman was mere coincidence, it wasn't. Besides offering a convenient metaphor for all the challenges the economy and its chief engineer are currently facing (not to mention the opportunity to relive a fond childhood memory…), the rails sector provided **a rare bit of good news** in an economy that has received very little good news recently: namely, **the resolution of a nationwide rail strike** that would've potentially re-snarled the still-not-quite-totally-unsnarled supply chain mess that was at least partially responsible for creating all this inflation in the first place.

And let's be clear, it was a fairly close call: a dozen railway unions were set to walk off the job last Friday, and the continued impasse was deep enough that **by Wednesday, Amtrak had begun cancelling long-distance passenger service** on routes that shared rails with freight traffic for fear of stranding travelers behind a wall of idled freight trains[4]. On Thursday, though, the final two union holdouts **reached a tentative deal,** and a potentially inflation-stoking crisis was averted, at least temporarily. (I say "temporarily" because the rank-and-file members of said unions must still ratify their agreements, which means we **may have to revisit this whole mess again** in the future if they don't[5].)

While it's impossible to know exactly how much damage a complete shutdown of the nation's rail system might have done (particularly since viable congressional remedies might have been available had negotiations failed,) it's probably safe to say that **the economy is unusually vulnerable** to something like that right now **because supply chains are still not completely over their bout with COVID**. For example, nearly all respondents to last week's Philly Fed survey of regional manufacturers reported that labor supply and supply chain difficulties continue to hamper output, and more than a third say supply chain difficulties are constraining output "significantly." Moreover, nearly three-quarters of those same **respondents aren't optimistic at all that supply chains will improve by year-end**.[6]

I, for one, had hoped that supply chains would have righted themselves by now. But that appears not to be the case, as Philly Fed and other recent, similar survey-based data seems to suggest. Now layer on top of that a nationwide shutdown of America's storied rail network **and it's hard not to be at least a little freaked out by what might have been**.

But in fairness, this might simply be a case of over-emphasizing a sector of the economy that has always seemed under-emphasized to me: **transportation**. Longtime readers will know that I pay particular attention to companies responsible for moving goods across our vast country **as a read-thru into larger macroeconomic trends**, and I'll freely admit that I might be guilty of reading too much into things like over-stuffed ports and narrowly-averted rail strikes for my own good. But I'm not alone in this (in fact, that notion is one key component of "Dow Theory" – one of the oldest and most persistent ways to chart the progress of the stock market,) which makes what I'm about to point out almost as unsettling as all the what-might-have-beens associated with striking railroad workers: **FedEx's big ugly profit warning**.

[2] Cme.com
[3] https://www.bls.gov/news.release/ppi.nr0.htm
[4] https://media.amtrak.com/2022/09/amtrak-ceo-stephen-gardner-statement-on-tentative-railway-labor-agreement/
[5] https://www.politico.com/news/2022/09/15/rail-unions-biden-negotiations-00056878
[6] https://www.philadelphiafed.org/-/media/frbp/assets/surveys-and-data/mbos/2022

After Thursday's market close, **FedEx** (which, by one possible interpretation is a modern-day heir of the railroad monopolies of the 19th century,) delivered what can only be described as a **massively disappointing update**, warning investors that the fiscal quarter ended August 31st would fall well short of previous expectations because of a **swift decline in package volumes during the last few weeks of the quarter**. Those declines – which the company attributed primarily to difficulties in Asia and Europe – were nonetheless steep enough and swift enough to force the company to throw up its hands and **withdraw any previous earnings forecasts for the rest of fiscal 2023** (and even compelled the company to reduce flight operations and **park some of its aircraft**)[7]. That's significantly different than earlier profit warnings from FedEx, which focused on rising costs and tight capacity amid demand that was too *strong*, versus volumes that are collapsing so fast that they're forced to park planes.

That's a negative read-through for the economy no matter how you slice it. But I suppose as with all clouds there is a silver lining: at least its **finally some tangible evidence that Powell's brake hand is working**.

What to Watch This Week: September 19th – 24th

Notable economic events (September 19th – 23rd)

Monday: NAHB builder sentiment

Tuesday: Housing starts/permits

Wednesday: FOMC decision, existing home sales

Thursday: Weekly jobless claims, Leading Indicators, KC Fed

Friday: Flash PMI

Source for index data: Bloomberg.com; GWI calculations.

I'd like to pretend that something other than Wednesday's rate announcement matters, but it probably doesn't. Sure, the **slate of housing market data** scheduled for release this week will matter in the long run, not least of which because inflation numbers are finally starting to recognize what everybody else has known for a long time: namely that out-of-control **housing costs are finally stoking the inflationary flames in a very real way**. If relief on that score is anywhere on the horizon, it will have to start with improving builder sentiment and increased building activity. Monday's builder sentiment survey by the NAHB and Tuesday's starts/permits release could drop a few hints.

But none of that will matter much in the short-term. Barring some kind of out-of-left-field event (like another dramatic profit warning from a macro-relevant company, renewed rail strike concerns or a massive escalation of the Ukraine conflict,) **markets will remain almost entirely focused on the Federal Reserve's decision and Powell's post-FOMC conference call** on Wednesday. The Fed finds itself in a very sticky situation when it meets this week: if it tightens policy too much – say, by boosting the federal funds rate by 1.00% – markets will likely react very poorly. But if it doesn't tighten *enough* — like, if it instead chooses to boost by only 0.50% - the Fed runs the risk of allowing inflation to run unchecked.

Everyone's base case is still 0.75%, but last Tuesday's CPI release put 1.00% very much within the realm of possible outcomes. For what it's worth, I'd be far more surprised by an increase of 0.50% than I would be of a full 1.00% increase, if for no other reason than **a measly half-point increase would likely cause risk markets to almost immediately rally back** to where they were in mid-August, before the Fed started talking tough again. It's even possible, I suppose, to argue that **a 0.75% increase might also have some of that same mojo** attached to it because it would prove to the optimists that the Fed still has a heart. That, I think its safe to say, is something the Fed would definitely *not* like to see. Given that, **I'm in the camp that believes a full 1% might actually happen**.

Regardless, the **litany of pressures** aligned against both the economy and riskier segments of the market is large enough and broad enough that **I worry we haven't seen the last of market volatility like that which we saw last Tuesday**, **no**

[7] http://investors.fedex.com/news-and-events/investor-news/investor-news-details/2022/FedEx-Reports-Preliminary-First-Quarter-Financial-Results-and-Provides-Update-on-Outlook/default.aspx

matter what the Fed decides to do. That said, each Fed increase, each corporate profit warning and every eye-watering market drawdown brings us a step or two closer to the point where the Fed can finally step back and let the US economy do its thing. That, if anything, should strike an optimistic chord with all of us.